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Two-Tiered Tender Offers and the Poison Pill: The Propriety of a Potent Takeover Defense

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Comments

Two-Tiered Tender Offers and the Poison Pill: The Propriety of a Potent Takeover Defense

Contests for corporate control occur frequently in corporate America.[1] Complex strategies and ingenious tactics have been developed both to facilitate takeovers and to defend against them.[2] Tender offers[3] currently affect millions of shareholders.[4] The tender offer process begins when an individual or business entity, commonly referred to as the bidder, decides to attempt a takeover. The bidder attempts to gain control of a corporation, the target company, by offering to purchase a specified number of shares of stock from the shareholders of the target company at a price above market value.[5]

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1. Norlin Corp. v. Rooney Place Inc., 744 F. 2d 255, 258 (2d Cir. 1984).
2. *Id.*
3. *See infra* notes 21-27 and accompanying text.
4. *See* Comment, *"Leg-Ups" and "Lock-Ups": An Analysis of Manipulation Under Section 14(e) of the Williams Act.* 49 ALBANY L. REV., 478, 478 (1985).
5. H. BLOOMENTHAL, 1984 SECURITIES LAW HANDBOOK 324 (1984). The bidder bids for shares at a premium in the hope that a majority of the outstanding shares will be tendered. A bidder will usually condition its offer upon the ultimate tender of the number of shares necessary to gain control. Dan River, Inc. v. Icahn, 701 F. 2d 278, 288 (4th Cir. 1983); *see also* 1 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS, §1.07(5)(b) (1984). The offer is made to the shareholders, not the corporation. *Id.* Neither the Williams Act, 15 U.S.C. §§78m(d)-(e), 78n(d)-(f) (1982), nor the Securities and Exchange Commission (SEC) rules and regulations define "tender offer." Profusek, *Federal Decisional Law Under the Williams Act,* 31 CLEV. ST. L. REV. 175, 192 (1982); Note, *The Developing Meaning of "Tender Offer" Under the Securities and Exchange Act of 1934,* 86 HARV. L. REV. 1250, 1250 (1973) [hereinafter cited as *The Developing Meaning of of Tender Offer*]; *see* Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y.) (1979), *aff'd on other grounds* 682 F. 2d 355 (2d Cir. 1982) *cert. denied,* 460 U.S. 1069 (1983). The court in *Wellman* stated that several factors are important in determining what constitutes a tender offer under the Williams Act:

   > (1) active and widespread solicitation of public shareholders for the shares of an issuer; (2) solicitation made for a substantial percentage of the issuer stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed

A tender offer is "hostile" if the directors of the target company decide to resist the attempt of the bidder to gain control.[6] A technique that is frequently used by takeover bidders is the front-end loaded, two-tiered tender offer.[7] Resistance by those in control of the target company may take the form of a variety of "defensive tactics."[8]

One of the newest and most effective defensive weapons utilized by the board of directors of a target company to ward off actual or perceived two-tiered tender offers is poison pill preferred stock.[9] The issuance of the poison pill stock evidences a clash of fundamental interests within the corporate structure between the unrestricted right[10] of shareholders to accept a tender offer bid and the ability of the board of directors to increase the bargaining power of the target company.[11] In the recent case of *Moran v. Household International Inc.*,[12] the board of directors of Household adopted a poison pill plan that may be the most potent defensive tactic yet devised.[13]

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maximum number to be purchased; (6) offer open only for a limited period of time; (7) offeree subject to pressure to sell his stock.

475 F. Supp. at 823-24. These factors were extracted from a list of elements included in an amicus curiae brief submitted by the SEC. *Id.* at 824.

6. *See* Comment, *supra* note 4, at 478-79.

7. *See infra* notes 28-46 and accompanying text. The two-tiered bid is a recent phenomenon. *See* Comment, *The Front-End Loaded, Two-Tiered Tender Offer,* 78 N.W. U.S. REV. 811, 812 (1983). Front-end loaded bids offer greater consideration in the first tier of the transaction. Issues arising from "partial" tender offers and "equal consideration two-step offers" are beyond the scope of this comment. In a partial offer, the bidder makes a tender offer for less than all the shares of the target company but does not state any intention to purchase the remaining shares. In an equal consideration two-step offer, the consideration in the second step merger is equivalent in amount to the front-end bid price. *See* Comment, *Front-End Loaded Tender Offers: The Application and State Law to an Innovative Corporate Acquisition Technique,* 131 U. PA. L. REV. 389, 396-97 (1982).

8. A "defensive tactic" may take two forms. First, the tactic may be responsive and possible only after an offer is made. Second, a defensive tactic may also be a precautionary measure taken by a corporation that is fearful of becoming a target. Advanced planning is sometimes called a "shark repellant." The purpose of a shark repellant, however, is to prevent an offer from being made, not to defend against the offer. *See* 1 A. FLEISCHER, JR., TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 11 (1983); R. WINTER, M. STUMPF AND G. HAWKINS, SHARK REPELLANTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER 3-7 (1983). *See* HOUSE COMM. ON ENERGY & COMMERCE, EQUITY IN FOREIGN AND DOMESTIC CREDIT AND TENDER OFFER REFORM, H.R. REP. No. 1029 98th Cong., 2d Sess. 6-7 (comprehensive list of defensive strategies).

9. *See infra* notes 108-124 and accompanying text.

10. In adopting the Williams Act, Congress was concerned that shareholders should have a fair opportunity to consider tender offers on the merits of the offer. The House and Senate Reports on the Williams Act demonstrate that Congress intended that the shareholders be the actual decision makers in the tender offer process. S. REP. No. 550, 90th Cong. 1st Sess. 3 (1967); H. R. Rep. No. 1711, 90th Cong., 2 Sess. 4 (1968).

11. Moran v. Household International Inc., Del. Ch., 490 A. 2d 1059, 1074 (1985). The board of directors of the target company increase their bargaining power by limiting the ability of a bidder to gain control by fragmentary acquisitions of shares. *Id.*

12. *Id.*

13. *See infra* notes 173-185 and accompanying text.

This comment will first explain the two-tiered tender offer and show how the bidder attempts a hostile tender offer utilizing the two-tiered method.[14] The effect of two-tiered bids on shareholders and on the target company will then be examined.[15] Economic arguments will demonstrate that encouraging an active market for corporate control is sound public policy.[16] Following a discussion of defensive tactics in general, the effects of poison pill preferred stock will be considered.[17] This comment will then discuss state fiduciary law and the appropriate standard for reviewing the decision of the directors to issue poison pill preferred stock.[18] *Moran v. Household International Inc.* will then be examined, focusing on the poison pill plan adopted by the directors of Household and the standard of review adopted by the court.[19] This comment will conclude by proposing that the directors of a target company must show a compelling business purpose justifying a defensive action that blocks all hostile two-tiered takeovers.[20]

TENDER OFFERS

A. Background

A tender offer is a publicly made invitation, addressed to all shareholders of a target company, to tender their shares for sale at a specified price to the bidder.[21] Cash or other securities may be offered to the shareholders as consideration for their shares.[22] The specified consideration usually represents a premium over the current market price of the securities sought.[23] The opportunity to tender shares at a premium remains open for a limited period of time.[24]

A tender offer can be used to acquire stock for the purpose of a takeover attempt of a target company.[25] Another purpose for a stock

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14. *See infra* notes 28-46 and accompanying text.
15. *See infra* notes 71-79 and accompanying text.
16. *See infra* notes 47-70 and accompanying text.
17. *See infra* notes 80-124 and accompanying text.
18. *See infra* notes 140-172 and accompanying text.
19. *See infra* notes 173-209 and accompanying text.
20. *See infra* notes 210-229 and accompanying text.
21. The term tender offer is inappropriate. The party making the announcement does not offer to tender shares; instead, others are invited to tender their shares. *The Developing Meaning of Tender Offer, supra* note 5, at 1251 n.7 (1973).
22. The term "cash tender offer" refers to tender offers in which the consideration is cash and an "exchange tender offer" is a tender offer in which the consideration is securities. *Id.* at 1251 n.8.
23. One survey reported that the median price offered to shareholders in cash tender offers was sixteen percent over the market price of the desired shares two days before the offer. *Id.* at 1251 n.9.
24. *Id.* at 1252.
25. *Id.* at 1253.

acquisition is to enable a corporation to purchase its own shares for nontakeover purposes.[26] The tender offer is an important takeover weapon that has replaced the proxy contest as a favored means of overcoming the resistance of an acquisition by incumbent management.[27]

B. *The Two-Tiered Tender Offer*

A major development in the tender offer process has been the emergence of the front-end loaded, two-tiered tender offer.[28] The two-tiered tender offer involves a single attempt to acquire one hundred percent control of a target corporation in two steps. In the first step the bidder acquires, usually for cash, enough shares to establish a controlling interest.[29] To guarantee success in the first tier, the bidder offers to purchase shares at a premium over market price.[30] In the second tier, the bidder acquires the remainder of the shares of the target company in exchange for cash or securities worth less than the cash paid in the first tier.[31] Therefore, in a two-tiered tender offer the bidder will pay more consideration in the first tier than in the second tier. For example, rather than pay all the shareholders an average price of fifty dollars, the bidder will buy fifty percent of the shares at sixty dollars per share to assure the acquisition of a controlling interest. After a controlling interest has been acquired, the bidder will pay forty dollars for each share in the second tier.[32]

The two-tiered tender offer is useful to the bidder for two reasons. First, the two-tiered tender offer increases the chances the bidder will be successful, because of the pressure on target company shareholders to tender their shares before the expiration of the first tier offer.[33] The strategy of the two-tiered tender offer is to create a stampede

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26. *See* D. AUSTIN AND J. FISHMAN, CORPORATIONS IN CONFLICT—THE TENDER OFFER 7 (1970). Another nontakeover situation in which tender offers are often used is when a controlling shareholder seeks to increase the size of the block owned by that shareholder. *The Developing Meaning of Tender Offer, supra* note 5, at 1253, n.15.

27. *See The Developing Meaning of Tender Offer, supra* note 5, at 1253. The tender offer has been found to be simpler and cheaper than the proxy contest in takeover attempts. *Id.*

28. *See* Fleisher, *Sun Shines on Bidders in Corporate Takeover World,* Legal Times of Wash., Jan. 25, 1982, at 15, Col. 1 (suggests the major significance of two-tiered tender offers). The front-end loaded, two-tiered tender offer will be referred to as the two-tiered tender offer. Other types of tender offers are beyond the scope of this comment.

29. *Id.*

30. *Moran,* Del. Ch. 490 A. 2d at 1067, n.2.

31. Fleisher, *supra* note 28, at 15, col. 1.

32. *See* Greene and Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions,* 132 U. PA. L. REV. 647, 677 (1984).

33. *Id.*

of tendering shareholders who must tender their shares or run the risk of losing the high front-end price.[34] Second, the two-tiered tender offer is a less expensive method for gaining one hundred percent control than a partial tender offer when the bidder decides only after gaining control to acquire the remainder of the outstanding shares.[35]

After the bidder has obtained control the remaining shares typically sell for substantially more than the market price prevailing prior to the tender offer, though less than the amount offered in the tender offer.[36] If the bidder later decides to acquire the remaining outstanding shares, the bidder will have to pay a second premium over the prevailing market price.[37] A bidder making a two-tiered tender offer sets the price of the second tier and the first tier at the same time.[38]

A two-tiered tender offer will have a lower total cost to the bidder than a partial tender offer since a partial tender offer involves two separate transactions, both involving the payment of a premium.[39] Although bidders enjoy the use of two-tiered tender offers, this tactic has been harshly criticized by commentators.[40] In addition, use of the two-tiered tender offer has sparked shareholder and target company litigation. The principal charge against two-tiered tender offers is that they coerce target shareholders into tendering shares in the first step, thereby preventing other potential bidders from bidding for the target.[41]

An element of coercion is inherent in the tender offer process.[42]

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34. *Id.*

35. *See* Comment, *Front End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique.* 131 U. PA. L. REV. 389, 389 (1982).

36. *Id.* at 389 n.5.

37. *Id.* One commentator reports that among a group of 26 recent acquisitions of minority shares by the bidder, all but one were at a premium over market value of at least 10 percent, and 85 percent were at a premium of at least 35 percent. Chazen, *Fairness from a Financial Point of View in Acquisition of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?,* 36 BUS. LAW. 1439, 1445 n.36 (1981).

38. Comment, *supra* note 35, at 389 n.5.

39. *Id.*

40. Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297, 337 (1974). (First comprehensive attack on partial and two-tiered tender offers appeared in Brudney & Chirelstein); *see generally* Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations,* 71 CALIF. L. REV. 1072 (1983) (unequal sharing of gains between two groups of shareholders unfairly defeats their expectations); Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes,* 1980 AM. B. FOUND. RESEARCH J. 69 (some two-tiered tender offers inefficient); Bebchuk, *The Case for Facilitating Competing Tender Offers,* 95 HARV. L. REV. 1028 (1982) (considering the beneficial effects of the two-tiered tender offers); Mirvis, *Two-Tier Pricing and "Entire Fairness": Valuation Issues,* 38 BUS. LAW. 485 (1983) (two-tiered bidders risk the dissatisfaction of second step shareholders and possible suits under Delaware's entire fairness standard).

41. *See supra* note 40 and accompanying text.

42. Radol v. Thomas, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982). The court in *Radol* held that a two-tiered tender offer, despite its coercive quality, did not constitute a "fraudulent,

Any tender offer to purchase stock at a premium over the market price results in pressure on the shareholders of the target company to tender their shares in the first tier of the takeover attempt. The coercive nature of two-tiered tender offers has been noted by courts,[43] commentators,[44] and the advisory committee of the Securities and Exchange Commission.[45] Use of the two-tiered tender offer raises the possibility that heightened pressure on the shareholders will lead them to tender their shares before evaluating the merits of the sale.[46]

C. Benefits of Hostile Tender Offer to Shareholders and Corporations

In many instances, corporate takeovers are beneficial exchanges of corporate control that result in more efficient management of the resources of the target company.[47] If incumbent management performs poorly, share prices will reflect substandard performance by falling below the highest potential value of the shares on the open market.[48] A profit opportunity then exists for a bidder to purchase the undervalued shares, replace poor management with competent management, and reap the benefits.[49] The bidder will receive benefits through the increased earnings of the acquired target.[50] The shareholders who sold in the first tier benefit from the high premium they received. Moreover, a two-tiered tender offer generally gives remaining shareholders an

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deceptive or manipulative" act or practice in violation of section 14(e) of the Exchange Act, 15 U.S.C. §78n(e) (1982). *Id.* at 1312.

43. *See, e.g.,* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 630 (D. Md. 1982); Radol v. Thomas 534 F. Supp. 1302, 1312 (S.D. Ohio 1982).

44. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 HARV. L. REV. 297, 337 (1974) (a comprehensive attack of partial and two-tiered tender offers); Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Offers: The Validity of Fair Price, Mandatory Bid, and Flip-over Provisions Under Delaware Law,* 11 SEC. REG. L.J. 291, 291-93 (1984) (an examination of modern defensive tactics to protect target shareholders from partial and two-tiered tender offers); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation,* 83 COLUM. L. REV. 249, 307 (1983) (bidders are exploiting the unequal bargaining position of the target shareholders); Mirvus, *Two-Tier Pricing: and "Entire Fairness": Valuation Issues,* 38 BUS. LAW. 485, 489 & n.8 (1983) (two-tiered bidders risk the dissatisfaction of second step shareholders and possible suits under Delaware's entire fairness standard). *But see* Easterbrook & Fischel, *Corporate Control Transactions,* 91 YALE L. J. 698, 727 (1982) (the premium offered to those shareholders tendering in the first tier compensates for the risk undertaken and for the facilitation of the transfer of control).

45. Advisory Comm. On Tender Offers, Sec. & Exch. Comm'n, Report Of Recommendations 25-26 (1983).

46. Greene and Junewicz, *supra* note 32, at 679.

47. Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers,* 23 J.L. & ECON. 371, 380-81 (1980).

48. *Id.*

49. *Id.*

50. Lowenstein, *supra* note 44, at 273.

opportunity to sell their shares in the second tier at prices that are generally better than those available on the market.[51] The beneficial result of the two-tiered tender offer occurs because the tender offer anticipates real gains in productivity.[52]

The threat of a hostile takeover has become an important mechanism for checking the efficiency of management.[53] The market for corporate control[54] is an effective device for limiting management discretion.[55] A decrease in corporate profits will be reflected in a decrease in the price of the stock of the potential target company.[56] Typically, a bidder will make a tender offer when the price of stock of the target company drops below the value of the stock.[57] A bidder will try to purchase a majority of shares at a price that is less than the actual value of the shares.[58] If the bidder can acquire shares for a price less than the actual value of the shares, then both the shareholders, who sell at a premium, and the bidder, who acquires desired shares, receive a benefit from the transaction.[59] The only parties to suffer from the takeover are the managers who will be removed by the successful bidder.[60]

Empirical research studies have concluded that the stock of target companies significantly underperforms the market before a tender offer is made.[61] One study concluded that the stock of target companies

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51. Greene and Junewicz, *supra* note 32, at 681.

52. Lowenstein, *supra* note 44, at 273.

53. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841 (1981).

54. *Id.* The market for corporate control involves the purchasing of securities in order to transfer control of the target company. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* The drop in the price of the stock of the target company creates an opportunity for entrepreneurial profit. *Id.*

58. Many types of costs may be incurred during a hostile tender offer. *See* Gilson, *supra* note 53, at 841 n.86 (comprehensive list of various transaction costs). One empirical study has estimated that transaction costs may amount to at least 13 percent of the post-offer market price of the target's shares. Smiley, *Tender Offers, Transaction Costs and the Theory of the Firm*, 22 REV. ECON. & STAT. 22 (1976).

59. Gilson, *supra* note 53, at 841-42.

60. *Id.*

61. Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980); Dodd & Ruback, *Tender Offers and Stockholder Returns*, 5 J. FIN. ECON., 351 (1977); Kummer & Hoffmeister, *Valuation Consequences of Cash Tender Offers and Stockholder Returns*, 33 J. FIN. 505, 509 (1978); Langetecq, *An Application of a Three-Factor Performance Index to Stockholder Gains from Merger*, 6 J. FIN. ECON. 365 (1978). One commentator stated:

> These results present a fairly consistent pattern. Acquired firms perform poorly before acquisition and gain significantly upon acquisition. . . . These results . . . show that acquired firms typically benefit from being acquired because their performance prior to the merger was below average and was improved by the acquisition. This

may underperform by as much as fifty percent of the potential value of the stock.[62] Tender offers are also beneficial because the directors may lack the necessary business opportunities or financial strength to increase profits.[63] Therefore, a target company may be more profitable if taken over by the bidder.[64]

In some instances, however, the tender offer process is not beneficial to the shareholders or the target company. A corporate raider is an investor who purchases a significant block of the stock of a target company on the open market.[65] The corporate raider will attempt to sell those shares back to the corporation at a premium.[66] The attempt to sell the shares back to the corporation at a premium is called "greenmailing" the corporation.[67] If the corporate raider cannot negotiate a premium for the stock, the corporate raider can threaten to mount a proxy fight either to elect new management or to "bust up" the target company by selling the assets piecemeal.[68] The corporate raider may also threaten to launch a tender offer to win control and then liquidate the target company.[69] Therefore, justifying the practice of corporate raiders may be difficult.[70]

The tender offer process is generally an effective mechanism by which control may be shifted to more efficient managers. The controversial[71] two-tiered tender offer is one type of tender offer that is an extremely strong and attractive acquisition technique used by bidders. The two-tiered tender offer, though coercive in nature, is beneficial to most parties to the transaction. Much support for the two-tiered tender offer exists, however, because acquisition costs for the bidder are reduced.[72] Moreover, the two-tiered tender offer induces the early tendering of shares.[73] Scholars

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> confirms that the corporate merger is indeed a device for transferring assets out of the hands of less competent managers into the hands of more competent ones . . ..

Asquith, Unpublished Paper, excerpt reprinted in ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 229-31 (R. Posner & K. Scott (eds. 1980).

62. *See* Gilson *supra* note 53, at 852-53.
63. *Id.* at 853.
64. *Id.*
65. Greene and Junewicz *supra* note 32, at 706.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 HARV. L. REV. 297, 337 (1974). Individual stockholders of the target company would have difficulty refusing the price for the shares in the first tier. The disparity between the two tiers would deprive the shareholders of the target company of their ability to make an informed decision as to whether the stockholders should accept the bid. *Id.*
72. Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?,* 19 GA. L. REV. 281, 320 (1985).
73. *Id.*

defend the two-tiered tender offer, arguing that the premium offered to the shareholders of the target company in the first tier compensates those who facilitate the transfer of control.[74] Scholars also defend the two-tiered tender offer by arguing that every shareholder of the target company has an equal opportunity to tender shares, and therefore, those that tender early should be compensated for facilitating the transfer of control.[75]

The overall effect of two-tiered tender offers is beneficial to shareholders.[76] The market price of the stock of the target company gains an average of thirty percent in the month surrounding a tender offer.[77] During a two-tiered tender offer, the blended premium, which represents the combined premium on an average of both tiers, generally reflects a significant increase over the pre-bid market price.[78] Therefore, real gains exist for the shareholders of the target company.[79]

Target management does not want the company taken over by a bidder who will remove them from their positions. To retain control of the corporation, target management will often implement a defensive tactic to thwart the bidders' takeover efforts. Defensive tactics are effective ways to prevent a bidder from gaining control, but these tactics are not always beneficial to the target company or to the shareholders of the target company.

Defensive Takeover Tactics

Defensive tactics fall into two categories. The first type is a financial transaction designed to reduce the attractiveness of a target to a bidder.[80] The second type of defensive tactic is a structural defense designed to make changes in control more difficult to accomplish.[81]

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74. Easterbrook & Fischel, *supra* note 44, at 727.
75. Dennis, *supra* note 72, at 320 n.185.
76. *See infra* note 77-79 and accompanying text.
77. *See* Moran, Del. Ch., 490 A. 2d at 1068 (testimony of Professor Michael C. Jensen.) To reach his conclusion, Professor Jensen used data contained in a Goldman, Sachs study of May 29, 1984 and material collected by the staff of the Securities and Exchange Commission. *Id.* at 1068.
78. *Id.*
79. The SEC recently released a study comparing various types of tender offers. SEC Release No. 34-21079, 16 Sec. Reg. L. Rep. (BNA) 1119 June 29, (1984). The study disclosed that the mean blended premium for two-tiered offers equaled 55.1 percent. The mean premium offered in the first tier equaled 83.5 percent, while the mean premium for the second tier equaled 47.1 percent. In nearly three-fourths of the two-tiered tender offers the difference between the first and second tier premiums was less than 20 percent. Dennis, *supra* note 72, at 321.
80. *See infra* notes 82-96 and accompanying text. A variance of a financial defensive tactic involves a special compensation agreement, also known as a "golden parachute," designed to give target officers and employees a measure of financial security if they lose their positions as the result of a change in control. Green & Junewicz, *supra* note 32, at 701, n.266.
81. *See infra* notes 97-114 and accompanying text.

A. *Financial Defenses*

A variety of corporate takeover financial defenses are available to the board of directors of a target company. One defensive tactic is liquidatation of the company in whole or in part.[82] This extreme financial action is known as the "scorched earth" defense.[83] Another option for target management is to sell an attractive subsidiary or other piece of corporate property to a friendly bidder who may subsequently make an offer that the target company will accept.[84] The sale by a target company of such property to a friendly buyer is known as a "crown jewel" sale.[85] Another type of a financial defense occurs when target management makes a tender offer for shares of the target company.[86] The actions of management make acquisitions of a controlling interest by a bidder more difficult.[87] A final example of a financial defense is when the target makes a tender offer for the bidding corporation.[88] This tactic is known as the "Pac-Man" defense.[89]

Financial defenses frustrate a tender offer in several ways. First, the target company becomes less attractive if substantial indebtedness has been incurred or an attractive asset has been sold.[90] Second, when target management decides to repurchase the shares of the target company, the shares begin to trade at a price above the tender offer price, forcing the bidder to offer more money to remain competitive.[91] Some financial defenses can involve the accumulation of target company stock in the hands of owners who will be unwilling to sell to a hostile bidder.[92] This accumulation may render a hostile tender offer impossible because the bidder cannot gain a controlling interest.[93] These financial defenses can be effective to halt the advances of a hostile bidder.

Financial defenses, however, may harm the shareholders of the target company. First, because the tender offer of the bidders has been thwarted, some of the shareholders of the target company will be

82. *See, e.g.*, Joseph Seagram & Sons, Inc. v. Abrams, 510 F. Supp. 860 (S.D.N.Y. 1981).
83. *Id.*
84. *See, e.g.*, Mobil Corp. v. Marathon Oil Corp., 669 F. 2d 366 (6th Cir. 1981); Marshall Field & Co. v. Icahn, 537 F. Supp. 413 (S.D.N.Y. 1982); Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982).
85. Greene and Junewicz, *supra* note 32, at 701.
86. *See, e.g.*, Schilling v. Belcher, 582 F. 2d 995 (5th Cir. 1978); Pogo Producing Co. v. Northwest Indus., Cir. No. H-83-2667 (S.D. Tex. May 24, 1983) (self tender offer).
87. Green and Junewicz, *supra* note 32, at 701-02.
88. *See, e.g.*, Martin Marietta Corp. v. Bendix, 549 F. Supp. 623 (D. Md. 1982).
89. *Id.*
90. Greene and Junewicz, *supra* note 32, at 702.
91. *Id.*
92. *Id.*
93. *Id.*

unable to sell their shares at a profit.[94] Second, implementing the defense may weaken the financial condition of the target company, resulting in a lower price for shares of the target.[95] The board of directors of a target company may implement financial defenses without shareholder approval.[96] Financial defenses are implemented after a bidder has begun a hostile tender offer.

B. Structural Defenses

Structural defenses are usually undertaken before a tender offer has been made.[97] These defenses make a change in corporate control more difficult. As with financial defenses a wide range of structural defenses are available to target management.

One type of structural defense is classification of the board of directors into two or more subgroups whose terms of office expire at different times.[98] Another structural defense occurs when the board of directors recommends to the shareholders that a supermajority provision be included in the articles of incorporation.[99] The supermajority provision requires that more than the legal minimum number of shareholders must approve any merger with or sale of substantially all of the assets of the target.[100] The supermajority provision comes into effect only when the merger or sale is to an entity owning more than a certain percentage, usually ten percent, of the stock of the target company.[101]

Another structural defense is a "fair price" provision. A fair price provision is the adoption of an amendment to the certificate of incorporation that requires a bidder to pay the same price to all shareholders of a target company.[102] These provisions deter two-tiered tender offers because the bidder will have to pay the same price in the second tier that was offered in the first tier.[103]

94. *Id.*
95. *Id.*
96. *Id.* at 702-03.
97. Greene and Junewicz, *supra* note 32, at 703.
98. This action of creating two or more subgroups of directors requires that even a majority shareholder must wait for at least two successive annual meetings to elect a majority of the board, assuming three subgroups of equal size. *Id.* at 703, n.277.
99. *Id.*
100. *Id.* The deterrent effect of a supermajority provision is very high when management controls enough shares to block the "supermajority" vote even if the bidder tenders for all outstanding shares. *Id.* at 703, n.278.
101. *Id.* at 703.
102. Finkelstein, *supra* note 44, at 295.
103. Greene and Junewicz, *supra* note 32, at 703-04.

Related to fair price provisions are mandatory bid provisions.[104] Mandatory bid provisions generally provide that once a threshold percentage of outstanding shares of a target company has been purchased by a bidder, the bidder must commence a tender offer for the remaining stock of the target company.[105] Mandatory bid provisions may provide that the mandatory tender offer price be at least equal to the greater of the highest price paid by the bidder in acquiring the initial threshold percentage or the highest market price prior to the tender offer.[106] The potential expense associated with mandatory bid provisions encourages potential bidders to negotiate with management.[107]

The latest structural defensive weapon used by the board of directors of target companies is poison pill preferred stock.[108] Poison pill preferred stock is distributed to the common stock shareholders of the target company as a dividend in the form of convertible preferred stock.[109] The preferred holders are entitled to redeem their shares for cash if the bidder acquires control of the target company.[110] The redemption price is the highest price paid for the shares of the target company in the year that the bidder gained control.[111] In addition, poison pill preferred stock contains a "flip-over" provision permitting the preferred shareholders to convert their preferred shares into common or convertible preferred stock of the successful bidder.[112] Poison pill preferred stock may be issued by the directors of the target company if the directors attained shareholder approval to create a class of preferred stock prior to the takeover bid.[113] Corporations may issue

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104. As with fair price amendments, the compulsory redemption provision can discourage two-tiered tender offers by requiring an offeror to buy a greater number shares at a higher price. *Id.* at 704, n.284.

105. Finkelstein, *supra* note 44, at 298.

106. *Id.*

107. Greene and Junewicz, *supra* note 32, at 704.

108. Poison pill preferred stock was introduced by Lenox, Inc. in a fight with Brown-Foreman Distillers Corp. *See* Wall St. J., June 16, 1983 at 2, col. 2. Issuance of the poison pill has since been announced by Bell & Howell Co. *See* Wall St. J., Aug. 16, 1983, at 12, col. 3; Superior Oil Co., Wall St. J., Nov. 25, 1983, at 4, col. 2; Warner Communications, Wall St, J., Jan. 13, 1984, at 4, col. 1; Moran v. Household International Inc., Del. Ch., 490 A. 2d 1059 (1985).

109. Poison pill preferred stock must be distributed on a pro rata basis without even the slightest degree of discrimination. *See* Telvest, Inc. v. Olson, No. 5798, slip. op. at 14-15 (Del. Ch. Mar. 8, 1979).

110. Note, *Protecting Shareholders Against Partial and Two Tiered Takeovers: The Poison Pill Preferred,* 97 HARV. L. REV. 1964, 1964-65 (1984).

111. *Id.* at 1965.

112. *See, e.g.,* Telvest, Inc. v. Olson, No. 5798, slip op. (Del. Ch. Mar. 8, 1979).

113. *See infra* notes 115-124 and accompanying text.

poison pill preferred stock under the authorization of "blank-check" provisions contained within state corporation statutes.[114]

Poison pill preferred stock issued under "blank-check" provisions has a high degree of flexibility.[115] The characteristics of poison pill preferred stock, as well as the decision to issue the stock, may be delayed until the target company perceives a takeover threat.[116] Blank-check stock originally developed as a device to facilitate the marketing of securities.[117] Blank-check provisions allow the board of directors to solicit capital in accordance with prevailing market conditions without delays associated with charter amendments or shareholder votes.[118] While preferred stock normally may be issued with shareholder approval, some states like Delaware[119] and California[120] permit the issuance of blank-check preferred stock by directors at their discretion. Furthermore, blank-check preferred stock may contain rights, preferences, privileges, and restrictions selected by the board at the time of issuance.[121] Accordingly, directors may determine any and all rights, preferences, or privileges under the blank-check stock provision.[122] A danger exists that the board of directors of a target company will use blank-check power at the expense of the shareholders of the target company.[123] With the power to issue blank-check stock, the directors of the target company may ward off

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114. *See infra* notes 115-124 and accompanying text.

115. *See* Finkelstein, *supra* note 44, at 299 (structural features of poison pill preferred stock).

116. *Id.*

117. *See* Note, *supra* note 110, at 1973 (Poison pill preferred stock may be validly issued under blank-check provisions).

118. *See* II W. FLETCHER, CYCLOPEDIA OF PRIVATE CORPORATIONS §5284.1 (rev. ed. 1971).

119. *See* DEL. CODE ANN. tit. 8, §§102(a)(4), 151(a) (1983).

> Every corporation may issue one or more classes or series of stock . . . which . . . may have such voting powers . . . and such designations, preferences . . . or other special rights . . . as shall be stated . . . in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation.

Id.

120. *See* CAL. CORP. CODE §202(e)(3).

121. CAL. CORP. CODE §202(e)(3) provides in pertinent part:

> If a corporation is authorized to issue more than one class of shares . . . the rights, preferences, privileges and restrictions granted to or imposed upon the respective classes or series of shares or the holders thereof, or that of the board, within any limits and restrictions stated, may determine or alter the rights, preferences, privileges and restrictions granted to or imposed upon any wholly unissued class of shares or any wholly unissued series of any class of shares. As to any series the number of shares of which is authorized to be fixed by the board, the articles may also authorize the board . . . to increase or decrease . . . the number of shares of any such series subsequent to the issue of shares of that series.

Id.

122. *See* CAL. CORP. CODE §202(e)(3), Legislature Committee Comment (1975).

123. Note, *supra* note 110, at 1974.

a potential tender offer that would be beneficial to shareholders.[124] By successfully thwarting the advances of a bidder, the board of directors of the target company will deny the shareholders of the target company the opportunity to decide who will manage the company. In an effort to protect shareholders, Congress enacted the Williams Act.

WILLIAMS ACT

By adopting the Williams Act,[125] the United States Congress expressed concern that shareholders should have the opportunity to consider tender offers on the merits of the offer.[126] Congress found that takeover bids should be encouraged because tender offers are helpful devices which provide a check on entrenched and inefficient management.[127] Congress did not want to deny shareholders the opportunities that result from the competitive bidding for a block of stock of a given company.[128]

The United States Supreme Court has also recognized that if hostile tender offers are blocked by management, shareholders will no longer be able to sell their shares at a premium.[129] The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered when target management blocks all two-tiered tender offers.[130] The tender offer creates the incentive for incumbent management to perform well so that stock prices remain high.[131]

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124. *Id.*

125. The Williams Act is part of the broad federal statutory scheme that regulates the securities market. 15 U.S.C. §§78m(d), 78n(d)(f) (1982).

126. Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 29, 30, 33 (1977). In *Piper*, the court concluded that Congress intended to protect the shareholders, "the pawn[s] in a form of industrial warfare." *Id.* at 30. The Williams Act, the Court continued, "is designed solely . . . for the benefit of investors." *Id.* at 31 (quoting 113 Cong. Rec. 24,664 (1967); *see also* Edgar v. MITE Corp., 457 U.S. 624, 633 (1982) ("There is no question that in imposing [the Williams Act] Congress intended to protect investors." (citations omitted)); 113 Cong. Rec. 854, 855 (1967) (stating that the purpose of the Williams Act is to require full and fair disclosure for the stockholder's benefit); HOUSE COMM. ON ENERGY & COMMERCE, EQUITY IN FOREIGN AND DOMESTIC CREDIT AND TENDER OFFER REFORM, H.R. REP. No. 1028, 98th Cong., 2d Sess. 6 (1984); HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, SECURITIES-CORPORATE EQUITY OWNERSHIP-DISCLOSURE, H.R. REP. No. 1171, 90th Cong., 2d Sess. 4, *reprinted in* U.S. CODE CONG. & AD. NEWS 2811, 2813 (1968); SENATE COMM. ON BANKING & CURRENCY, FULL DISCLOSURE OF CORPORATE EQUITY OWNERSHIP AND IN TAKEOVER BIDS, S. DOC. No. 550, 90th Cong., 1st Sess. 3 (1967) (stating that the Act was designed to "require full and fair disclosure for the benefit of investors while at the same time providing the offeror (bidder) and (target) management equal opportunity to fairly present their case.").

127. S. REP. No.. 550, 90th Cong. 1st Sess. 3 (1967).

128. Edgar v. MITE, 457 U.S. 624, 633 n.9 (1982).

129. *Id.* at 643.

130. *Id.*

131. *Id.*

The goal of the Williams Act is to give shareholders the opportunity to decide whether or not to accept a tender offer without undue interference from either the bidder or the target company.[132] Thus, tender offers are conducted through a national "market approach" in which the goal is to get information to the shareholders of the target company by allowing both the bidder and target management to present their arguments.[133] After arguments on both sides are made, the shareholders of the target company decide whether to tender their shares to the bidder.[134] Congressional committee reports on the Williams Act underscore the intention of Congress that shareholders, informed through full disclosure by both sides in the contest, should be the actual decisionmakers in the tender offer process.[135]

Poison pill preferred stock frustrates the ability of shareholders to make the choice that Congress viewed as being within the province of the shareholders.[136] A poison pill plan may give management an absolute veto over all hostile tender offers.[137] The effect of the poison pill is to entrench management.[138] Thus, the poison pill usurps the right of the shareholders to control who will manage the company.[139] The decision whether to accept or reject a tender offer should be left, after full disclosure by target management and bidders, to the shareholders. When the board of directors implements a poison pill plan, the question becomes whether target management is acting in the best interest of the shareholders of the target company.

STATE FIDUCIARY LAW AND THE STANDARD OF REVIEW

Corporate directors have a fiduciary duty to act in the best interests of the shareholders.[140] When the directors of the target company im-

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132. *Takeover bids: Hearings on H.R. 14,475 and S. 510 before the Subcomm. on Commerce and Finance on the House Comm. On Interstate And Foreign Commerce*, 90th Cong. 2d Sess. 4 47-48 (1968) (These hearings emphasized the need "to get information to the investor . . . and then to let the investor decide for himself.").

133. *Id.*

134. *Id.*

135. S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967); H. R. REP. No. 1711, 90th Cong., 2d Sess. 4 (1968); *see* Edgar v. MITE, 457 U.S. 624, 633-34 (1982); Rondeau v. Mosinee Paper Corporation, 422 U.S. 49, 58 (1975); Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 26-31 (1977).

136. *See* Great Western United Corp. v. Kidwell, 577 F. 2d 1256, 1279 (5th Cir. 1978); Edgar v. MITE Corp., 457 U.S. 624, 633-39 (1982) (opinion of Justices White, Blackman and Chief Justice Berger). *See also* National City Lines Inc. v. LLC Corp., 687 F. 2d 1122, 1129-30 (8th Cir. 1982); Kennecott Corp. v. Smith, 637 F. 2d 181, 189-90 (3d Cir. 1980).

137. *See infra* notes 174-185 and accompanying text.

138. *See infra* note 208 and accompanying text.

139. *See infra* note 196 and accompanying text.

140. *See* CAL. CORP. CODE §309 (Cal. Corp. Code §309(a) provides that:

plement a poison pill plan, the issue arises whether they have fulfilled their fiduciary obligations to the corporation and shareholders. The fiduciary duty imposed upon the directors requires that they block only those takeover bids that would be harmful to the target company.[141] Furthermore, the directors should not act in a self serving manner to preserve their own positions.[142] Therefore, target directors who implement a poison pill plan may be charged with seeking to perpetuate their own control and thus breaching their fiduciary duty.[143] This section will examine the standards by which the actions of the directors of the target company are judged when implementing a defensive tactic.

Courts review the decisions of corporate directors under the business judgment rule.[144] The business judgment rule is a common law principle that proscribes judicial inquiry into the substance of the day-to-day business decisions of corporate directors.[145] A simplified view of the business judgment rule is that no liability will be imposed on direc-

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Id.

141. *See, e.g.*, Treadway Cos. v. Care Corp. 638 F. 2d 357, 381 (2d Cir. 1980); Heit v. Baird, 567 F. 2d 1157, 1161 (1st Cir. 1977).

142. *See, e.g.*, Schnell v. Chris-Craft Indus., 285 A. 2d 437, 439 (Del. 1971).

143. *See* National Education Corp. v. Bell-Howell Co., No. 7278, slip. op. at 2 (Del. Ch. Aug. 25, 1983). The validity of the poison pill plan adopted by Bell & Howell was never determined. The court denied plaintiff's motion for a preliminary injunction on the grounds that plaintiff had failed to demonstrate a likelihood of succeeding on the merits of claims that the flip-over provision was valid. *Id.*

144. The business judgment rule has been stated in different ways; however, the rule does not vary significantly from one jurisdiction to the next. *See* cases cited at 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §1039 nn.2-6 (rev. ed. 1975). Fletcher summarizes the business judgment rule as follows:"The law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the heading of honest mistakes." *Id.* After analyzing cases considering the business judgment rule, S. Samuel Arsht proposed the following statement of the rule and limitations:

> A corporate transaction that involves no self-dealing by, or other personal interest of, the directors who authorized the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a director's performance of his or her duties, and directors who authorized the transaction will not be held personally liable for resultant damage, unless: 1. The directors did not exercise due care to ascertain the relevant and available facts before voting to authorize the transaction; or 2. The directors voted to authorize the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or 3. In some other way the director's authorization of the transaction was not in good faith.

Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111 (1979).

145. *See supra* note 144 and accompanying text.

tors for honest errors or mistakes of judgment when the directors act without corrupt motive and in good faith.[146] Without the protection of the business judgment rule, few qualified people would be willing to serve as directors.[147] Moreover, the courts are generally ill-equipped to evaluate the relative merits of contrasting business proposals.[148] According to the business judgment rule, the directors' decisions are presumed to be based on sound business judgment.[149] This presumption can be rebutted only by a showing of fraud, bad faith or gross overreaching.[150] The business judgment rule allows the directors to prevail whenever they can articulate a rational, unselfish business purpose for their actions.[151] Not surprisingly, the decisions of directors are rarely overturned when subjected to review under this lenient standard.[152]

The business judgment rule does not apply when a conflict of interest exists.[153] When a conflict of interest exists, the directors bear the burden of showing the "intrinsic fairness" of their actions.[154] Normally, proving intrinsic fairness requires a showing of the substantive fairness of the challenged action.[155] Nonetheless, since courts are ill-equipped to decide the complex business questions raised by a hostile tender offer, courts have not applied the intrinsic fairness test.[156]

When confronted with deciding the merits of the decision of management to oppose a hostile tender offer, courts use two standards. When a majority of the board consists of interested directors,[157] courts apply the primary purpose test. Under this test, the board bears the burden of proving that the challenged defensive tactic was motivated by a valid business purpose and that the valid purpose was the primary

146. *See supra* note 144 and accompanying text.

147. Comment, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control,* 76 NW. U.L. REV. 980, 983-84 (1982).

148. *Id.*

149. Panter v. Marshall Field & Co., 646 F. 2d 271, 293 (7th Cir. 1981), *cert. denied,* 454 U.S. 1092 (1981).

150. *Id.*

151. *See e.g.* Johnson v. Trueblood, 629 F. 2d 287, 292 (3rd Cir. 1980) *cert. denied,* 450 U.S. 999 (1981).

152. *See* E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75-81 (1972). *But see* Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees,* 4 DEL. J. CORP. L. 652, 657 (1979).

153. *See, e.g.* Cohen v. Ayers, 596 F. 2d 733, 73940 (7th Cir. 1979).

154. Lynch v. Cook, 148 Cal. App. 3d 1072, 1082, 196 Cal. Rptr. 544, 550 (1983).

155. *Id.*

156. *See* Comment, *supra* note 147, at 983-84.

157. A distinction exists between interested management directors and noninterested independent directors. When confronted with a takeover bid, interested directors stand to lose their management positions and salaries, while independent directors might lose only their directors' fees and whatever prestige accompanies the position. *Id.*

motivation for the defensive maneuver taken by the board.[158] The primary purpose test is necessary because of the inherent conflict of interest that exists.[159]

If, however, the board of directors of the target company includes a majority of "independent" nonmanagement directors, most courts hold that no conflict of interest exists and thus apply the more lenient business judgment rule.[160] The business judgment rule is applied because independent directors are less likely than inside management directors to implement a defensive strategy based on self-interest.[161] Since boards of directors include a majority of independent directors the primary purpose test can be viewed as being a limited exception to the business judgment rule.[162]

A. *The California Approach*

As in other jurisdictions, a director of a California corporation owes a fiduciary duty to the corporation.[163] California has adopted the view that a director will not be held liable for an honest mistake of business judgment.[164] California law permits the directors to take action without shareholder approval in certain situations. For example, statutes permit directors to amend the bylaws[165] or issue "blank-check" stock.[166] The statutes are silent, however, about the role of the target company directors in the tender offer context.

In California, as in other jurisdictions, directors may be ousted from their positions in the event of a successful hostile tender offer. Although corporations elect directors annually at the shareholders meeting,[167] a successful bidder does not have to wait for a shareholders meeting to install new directors. The successful bidder may remove

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158. *See, e.g.*, Treadway Cos. v. Care Corp., 638 F. 2d 357, 382 n.47 (2nd Cir. 1980).
159. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175 (1981).
160. *See* Panter v. Marshall Field & Co., 646 F. 2d 271, 294 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos., 638 F. 2d at 383; Buffalo Forge Co. v. Ogden Corp., 555 F. Supp. 892, 904 (W.D.N.Y.), *aff'd.* 717 F. 2d 757 (2d Cir.), *cert. denied*, 104 S. Ct. 550 (1983); Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 634 (D. Md. 1982); Whittaker Corp. v. Edgar, 535 F. Supp. 933, 951 (N.D. Ill. 1982); *but see* Klaus v. HiShear Corp., 528 F. 2d 225, 233-34 (9th Cir. 1975).
161. Note, *supra* note 110, at 1970.
162. *Id.*
163. CAL. CORP. CODE §309.
164. *Id.* §309, Legislature Committee Comment.
165. *Id.* §1101.
166. *Id.* §202(e)(3).
167. *Id.* §301(a).

the incumbent directors without cause,[168] and select replacements[169] either by written consent[170] or at a special shareholders' meeting called at the successful bidder's request.[171]

Case law has helped define the proper role of management. In California, the court has yet to face the issue of the propriety of the poison pill preferred defensive tactic. Recently in Delaware, however, the poison pill cleared a major legal hurdle and now other corporations are likely to implement poison pill plans. California and other jurisdictions should not follow the Delaware approach because the decision creates the potential for abuse of directorial authority.[172]

B. *Moran v. Household International Inc.*

In January of 1985 a Delaware court recognized the use of poison pill preferred stock in *Moran v. Household International Inc.*[173] *Moran* represents the first legal test of the poison pill preferred tactic. The Chancery court held that adoption of the poison pill plan by the board of directors of Household, without shareholder approval, was in the interests of the shareholders, and thus was a reasonable exercise of business judgment.

The poison pill plan adopted by Household was an unusually potent poison pill defense.[174] The complexity of the poison pill plan was designed to create uncertainty concerning the implications and effects of the plan on the part of a potential bidder.[175] The poison pill plan involved the issuance of stock rights to the common stockholders of Household to purchase one hundred dollars worth of Household preferred stock.[176] The stock rights issued by Household were, when

168. *Id.* §303.
169. *Id.* §305(a).
170. *Id.* §305(b).
171. *Id.* §305(c).
172. *Moran*, 490 A. 2d, at 1083. Moran v. Household International Inc. was recently decided by the Delaware Supreme Court. The Delaware Supreme Court affirmed the decision of the Delaware Court of Chancery and upheld the Rights Plan as a legitimate exercise of business judgment by Household. The Delaware Supreme Court held that the directors of Household adopted the Rights Plan in the good faith belief that it was necessary to protect Household from coercive acquisition techniques. The Delaware Supreme Court did note, however, that while the directors of Household were protected by the business judgment rule, the ultimate response to an actual takeover bid must be judged by the actions of the directors at that time, and nothing relieves the directors of their basic fundamental duties to the corporation and its stockholders. Moran v. Household International Inc. No. 37, slip. op (Del. Supr. Nov. 19, 1985).
173. 490 A. 2d 1059 (Del. Ch. 1985).
174. Amicus Curiae Brief for the Securities and Exchange Commission at 6, Moran v. Household International Inc., Del. Supr. No. 37, 1985.
175. *Moran*, 490 A. 2d at 1066.
176. *Id.*

issued, not separable from the common stock.[177] In addition, the stock rights were not exercisable, thereby preventing the holders from exercising their rights to purchase Household preferred stock.[178] The poison pill plan introduced by Household provided, however, that the stock rights would detach from the common stock and become exercisable if anyone made a tender offer for at least thirty percent of Household's stock, obtained twenty percent of Household's stock, acquired the right to purchase or to vote twenty percent of the stock, or formed a group holding twenty percent for the purpose of acting together.[179]

The stock rights issued by Household would be of consequence in one event. If a hostile tender offer for Household was successful, the rights would flip over so that the holders could purchase, for one hundred dollars per right, two hundred dollars worth of the stock of the bidding company.[180] In effect, the acquiring company would have to pay a net of 100 dollars worth of stock for each right held by a Household shareholder.[181]

The flip-over would only occur if the acquisition was the result of a hostile tender offer. Since the stock rights could be redeemed by the Household board for a relatively nominal amount of fifty cents each at any time before one of the twenty percent triggering events occurred, the board could remove the "poisonous" effect of the plan for any takeover of which the board approved.[182] Thus, the plan forced any bidder to seek and obtain approval from the board of the target company. The redemption privilege attached to the stock rights issued by Household discouraged hostile two-tiered tender offers because the stock rights permitted the shareholders to deplete the assets of the bidding entity.[183] If a bidder was unable to acquire a large percentage of a target company after the poison pill was issued, the dilution of the capital of the bidding entity would be immediate and devastating.[184] The board of directors of Household issued poison pill

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177. *Id.*
178. *Id.*
179. *Id.*
180. *Id.*
181. Household had approximately 60 million shares of common stock outstanding, which were trading at a price around 30 dollars per share. Household issued 60 million rights, one per share of common, each costing the acquirer a net of 100 dollars in payment to the right holder following a "flip-over." If all the rights issued by Household flipped over and were exercised, the bidder would be required to pay an extra $6 billion for the company, which at the time the plan was adopted had a market value of approximately $1.8 billion. Amicus Brief for the SEC, *supra* note 174, at 7-8.
182. *Moran*, 490 A. 2d at 1066.
183. *Id.*
184. *Id.*

preferred stock rights claiming that the issuance was necessary to protect the shareholders and the company from all coercive two-tiered tender offers.[185]

At the time the poison pill plan was adopted by the board of directors of Household, the board explicitly invoked the business judgment rule as authority for the action.[186] The board sought application of the same standard in the Delaware Court.[187] Plaintiff shareholders argued that the business judgment rule was not the proper standard since the poison pill plan would prevent the shareholders of Household from receiving tender offers.[188] The plaintiffs argued that the directors of Household had the burden of proving that the plan was fair and reasonable to the shareholders.[189]

The *Moran* court applied the business judgment rule to review the issuance of the poison pill preferred stock.[190] The court noted that since a majority of the directors of Household were independent, the presumption of good faith was heightened.[191] The *Moran* court also noted that the directors of Household implemented the plan as a response to general vulnerability.[192] Thus, the tactic was pre-planned rather than reactive.[193] The court emphasized that prospective contingency plans reduce the risk of ill-planned reactive devices which harm shareholder interests. Since the defense was pre-planned, the poison pill device was given the protection of the business judgment rule.[194]

The poison pill plan permitted the Household board to act as prime negotiator in the event of a hostile two-tiered tender offer.[195] The poison pill plan adopted by Household created a structural change in the relationship between the shareholders and the board of Household by giving the directors the ability to decide whether to accept a tender offer.[196] The court held that this structural change required the Household board to present evidence, notwithstanding the business judgment rule, to show that the poison pill plan was not motivated primarily by a desire to retain control.[197]

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185. *Id.*
186. *Id.* at 1074.
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.*
191. *Id.* at 1074-75.
192. *Id.* at 1075.
193. *Id.*
194. *Id.*
195. *Id.* at 1076.
196. *Id.*
197. *Id.*

Although the court found that the poison pill plan would virtually eliminate hostile two-tiered tender offers, they held that Household was not required to show the intrinsic fairness of the plan.[198] Rather, the directors had to meet the standard of the business judgment rule and show that the poison pill plan was reasonable at the time of adoption.[199] The *Moran* court held that the directors had the burden of going forward with evidence to show the reasonableness of their actions.[200] The directors, however, did not bear the burden of persuasion.[201] The directors did not have to prove that the plaintiffs were not entitled to relief.[202] Since directors are protected under the business judgment rule, the burden of persuasion remains with the party challenging the actions of the directors.[203] To withstand legal scrutiny under the *Moran* test, the decision of the directors to issue the poison pill need not be particularly compelling or persuasive.[204] The standard articulated in *Moran* does not protect the interest of the shareholders.[205] In practice, the directors need only give a plausible reason to justify their actions.[206]

The legal test adopted in *Moran* raises serious questions concerning the adequacy of protection given to target company shareholders.[207] Moreover, the *Moran* court noted that the poison pill plan adopted by the directors of Household was subject to potential abuse of directorial authority because the directors of Household had the ability to inflict harm upon the corporation by rendering Household takeover-proof.[208]

The *Moran* decision sets forth burden of proof rules that are virtually insurmountable for a shareholder attacking the decisions of corporate directors. A poison pill plan like the one adopted in *Moran* deserves greater scrutiny than the standard applied in *Moran*. The poison pill plan adopted in *Moran* would allow the directors to exercise arbitary power by using the poison pill to deter takeovers that might be in the best interests of all the shareholders.[209]

198. *Id.*
199. *Id.*
200. *Id.*
201. *Id.*
202. *Id.*
203. *Id.*
204. *See* Greene and Junewicz, *supra* note 32 at 717.
205. *See id.*
206. *See id.*
207. *See id.*
208. *Moran*, Del. Ch., 490 A. 2d at 1083.
209. *Id.*

PROPOSED STANDARD OF REVIEW

The California Supreme Court has held that a director is a fiduciary who holds powers of trust.[210] As a fiduciary, the director cannot serve personal interests first and shareholder interests second.[211] The director cannot use directorial power for personal advantage or to cause detriment of stockholders.[212]

In *Klaus v. Hi-Shear, Inc.*,[213] the United States Court of Appeals for the Ninth Circuit suggested a promising approach for dealing with the burden of proof issue. In *Klaus*, the directors of Hi-Shear authorized the issuance of shares for the acquisition of two subsidiaries and for formation of an employee stock option plan.[214] The issuance of the shares deterred Klaus' attempt to gain control of Hi-Shear.[215] The district court held that issuance of the stock option shares constituted wrongful use by the Hi-Shear directors of their corporate position.[216] In addition, the district court found that the directors acted to further their personal interests and were motivated primarily by an interest in maintaining control.[217] The burden of proof then shifted to the directors of Hi-Shear.[218] The appellate court required the defendants to show a "compelling business purpose" behind the defensive tactic.[219] The court characterized the compelling business purpose test as a fairness test intended to balance the positive effects to the corporation against the disproportionate advantage to majority shareholders and incumbent management.[220] The compelling business purpose test will protect shareholders from directors of a target company who implement a poison pill plan that blocks all two-tiered tender offers. The compelling business purpose test will prevent the directors of the target company from enacting a poison pill plan in order to entrench their management positions.

The compelling business purpose test has not yet been applied in any case in which control was found to be merely a contributing motivation.[221] No justification exists for corporate directors to issue

210. Heckmann v. Ahmanson, 168 Cal. App.3d 119, 126, 214 Cal. Rptr. 177, 182 (1985).
211. *Id.*
212. *Id.*
213. Klaus v. Hi-Shear, Inc., 528 F. 2d 225 (9th Cir. 1975).
214. *Id.* at 228.
215. *Id.* at 234.
216. *Id.* at 230.
217. *Id.* at 234.
218. *Id.* at 233-34.
219. *Id.*
220. *Id.*
221. *See* Comment, *supra* note 147, at 1010 n.145.

a poison pill that will block virtually all two-tiered tender offers.[222] Therefore, the directors should be required to justify a *Moran* type poison pill plan with a compelling business purpose. The *Klaus* test[223] will assure protection of the interests of shareholders from the inherent conflict of interest that arises when management adopts a defensive tactic that virtually eliminates all two-tier tender offers.

The board of directors of a target company cannot be presumed to act in the shareholders interests.[224] When a threat to control is involved, the directors of the target company are confronted with a conflict of interest, and an objective decision is difficult.[225] Hence, the burden should be placed upon the directors of the target company to justify a poison pill plan as one primarily in the corporate interests.[226]

The interposition of management as the sole authority for determining whether a tender offer should go forward is not a substitute for a vigorous market approach in which the shareholders decide.[227] The consistent view of Congress has been that the decision whether to accept or reject a tender offer should be left, after full disclosure by management and bidders, to shareholders.[228] The poison pill plan would undercut the process contemplated by the Williams Act by giving the target board a plenary negotiation role on behalf of the shareholders.[229] Such a scheme, renders the poison pill plan inherently contrary to the interests of the shareholders and a similar plan should not be upheld in California. *Klaus*, being a Ninth Circuit decision, is persuasive authority for California to extend the compelling business purpose test to a tender offer situation like *Moran*.

CONCLUSION

This comment has argued that hostile two-tiered tender offers are not destructive to the corporation and most shareholders. A poison pill plan similiar to the plan adopted in *Moran* goes far beyond the notion of legitimately protecting the interest of the corporation and shareholders. By resisting all two-tiered tender offers, management

222. Amicus Brief for the SEC, *supra* note 174 at 20.
223. *See Klaus*, 528 F.2d at 234 (9th cir. 1975).
224. Bennett v. Propp., Del. Supr., 187 A.2d 405, 409 (1962).
225. Cheff v. Mathes, Del. Supr., 199 A.2d 548, 554 (1964).
226. *Id.*
227. Amicus Brief for the SEC, *supra* note 174 at 29.
228. *Id.*
229. *Id.*

may deprive shareholders of the maximum profits from their investments. If the directors' resistance is not well founded, the directors should be liable to the shareholders for depriving them of the opportunity to tender their stock. This comment has suggested that a defensive tactic designed to block all two-tiered tender offers should be judged under a compelling business purpose test. The business judgment rule was never intended to allow directors to circumvent or ignore the best interests of the shareholders. The interests of the shareholders can only be protected by increasing the level of judicial inquiry into the performance of the directors duties. Application of the compelling business purpose test is necessary to protect the interests of the shareholders.

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